

PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298



October 20, 2003

TO: ALL PARTIES OF RECORD IN ORDER INSTITUTING RULEMAKING 01-10-024

Decision 03-10-058 is being mailed without the written Dissents of Commissioner Lynch and Commissioner Wood. The Dissents will be mailed separately.

Very truly yours,

/s/ ANGELA K. MINKIN
Angela K. Minkin, Chief
Administrative Law Judge

ANG:acb

Attachment

Decision **03-10-058** October 16, 2003

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Establish Policies and Cost Recovery Mechanism for Generation Procurement and Renewable Resource Development.

Rulemaking 01-10-024
(Filed October 25, 2001)

O P I N I O N

1. Summary

This decision grants Southern California Edison Company's (SCE) request for interim authority to hedge a confidentially specified portion of its first and second quarter 2004 natural gas price risk associated with its existing 2004 Qualifying Facility (QF) contracts that are tied to short-run avoided cost payment mechanisms.¹ SCE seeks Commission approval in advance of the decision on its 2004 short-term plan in order to lower its customers' potential exposure to natural gas prices and obtain more certainty as to the cost of QF energy.² We reject the Office of Ratepayer Advocates (ORA) recommendation that the

¹ The 2004 gas volumes related to these QF contracts and the estimated financial exposure that SCE seeks to hedge are set forth at pages 2 and 3 of the confidential version of its September 10 motion. We limit SCE's interim authority to the first six months of 2004 gas price risk because this is the critical period that needs to be hedged between now and our year-end decision on SCE's 2004 short-term procurement plan. PG&E and SDG&E have authority to hedge through the end of first quarter of 2004 under their adopted 2003 short-term procurement plans while SCE's existing hedging authority is under the terms of its Settlement Agreement and expires December 31, 2003 (See Decision (D.) 03-02-033.).

² SCE's 2003 hedging authority is under the terms of its Settlement Agreement with the Commission. (See Decision (D.) 03-02-033.)

reasonableness of the price of SCE's hedges will be determined by using specified New York Mercantile Exchange (NYMEX) data sources. In response to the recommendation of The Utility Reform Network (TURN) that SCE review specific details of its hedging strategy and proposed actions with its Procurement Review Group (PRG) at the earliest possible date, we find that we agree with TURN's concern that SCE's request is overbroad but choose a different procedural remedy. We simply limit the time period for which SCE can hedge gas prices to no later than July 1, 2004. For hedges extending beyond that date, SCE will operate under our approved 2004 procurement plan anticipated for decision in December 2003. We also encourage SCE to continue discussing its hedging philosophy and strategy with its PRG.

2. SCE's Request

On September 10, 2003, SCE filed a motion for interim authority to hedge QF natural gas price risk for 2004 and for expedited consideration. SCE states that it has requested this authority in its 2004 Short Term Procurement Plan; however, it has now determined it needs authority prior to the scheduled December 18, 2003 Commission decision on its plan. In support of its need for immediate authority, SCE cites the natural gas price volatility at the Southern California border and at Malin in northern California over the last two years.

SCE requests the Commission shorten time for responses to its motion to September 17, 2003 and waive the provisions of Rule 77.7 of the Commission's Rules of Practice and Procedure, addressing public review and comment on draft decisions. SCE states that it has discussed the relief it seeks here with members of its PRG and believes the motion will be uncontested, although parties may file limited comments addressing certain details regarding the implementation of SCE's request.

On September 18, 2003, the assigned Administrative Law Judge issued a ruling shortening time for responses to September 23, 2003 and stating that the matter would be handled on an expedited basis with the public review and comment period reduced but not waived.

3. Parties' Response to Motion

On September 17, 2003, ORA and TURN filed responses to SCE's motion. Both parties state that the public interest is best served if SCE is allowed to begin hedging in October 2003 rather than January 2003 provided the Commission adopts specific modifications.

ORA agrees with SCE's proposed level of interim authority, a confidential percentage of its natural gas price risk associated with its 2004 QF contracts. This percentage is less than SCE requests in its 2004 short term plan, and is consistent with ORA's recommended percentage limit in the hearing record.

ORA states that SCE's motion seeks permission to hedge using NYMEX futures and options, over-the-counter options, broker basis swaps and bilateral basis swaps. ORA recommends the Commission rule that the reasonableness of SCE's hedges will be determined by comparing SCE's hedge transactions to similar transactions in the NYMEX market, using the following NYMEX data sources:

Table 1: ORA Recommended Data Sources

Contract	Market Benchmark
Futures	NYMEX Natural Gas Futures
Options	NYMEX Natural Gas Options
Malin Basis Swaps	NYMEX ClearPort Malin Basis Swap (NOI)
SoCal Basis Swaps	NYMEX ClearPort SoCal Basis Swap (NGI)

TURN states it shares SCE's concerns regarding the ratepayer risks associated with potentially volatile natural gas prices in 2004 and supports the

motion subject to a process limitation that would prevent SCE executing hedges without prior consultation with its PRG. TURN states this condition is necessary because SCE has presented the PRG with a wide range of hedging options that do not adequately demonstrate the particular criteria that will be used in deciding the types and quantities of products to be utilized. Therefore, according to TURN, SCE should be required to share relevant details (actual market data, any internal analyses, and proposed actions) along with an explanation of its underlying hedging “philosophy” with the PRG at the earliest possible date.

On September 25, 2003, SCE filed its reply to the responses of ORA and TURN. SCE objects to the modifications requested by each party that they would limit SCE’s flexibility to exercise judgment within the established boundaries on a real-time basis. SCE urges the Commission to reject the modifications proposed by ORA and TURN and grant, as expeditiously as possible, SCE interim authority to hedge a portion of its QF natural gas price risk for 2004.

4. Discussion

Both ORA and TURN agree that SCE should be allowed to hedge some portion of its natural gas price risk associated with 2004 QF contracts but that additional mechanisms need to be in place to ensure value to ratepayers. SCE proposes a specific methodology for setting maximum volume limits on trading, as set forth in Appendix A to its motion, but does not specify the criteria it will use to determine the value of a hedge or the price to pay for a hedge. ORA's proposed modification is designed to ensure that SCE buys reasonably priced hedges at the time of purchase. TURN, while supportive of ORA's concerns, is more interested in SCE's hedging “philosophy.”

We see TURN’s concern going to the issue of whether there is a value to ratepayers in each hedging transaction. TURN addresses its concern by

requesting more detailed PRG consultation, a proposal that SCE rejects due to timing considerations. We, however, agree with TURN that SCE should continue to inform its PRG about its hedging decisions and strategies, but will not require that consultation in advance of SCE's entering any transactions. We will require, instead, that SCE share with its PRG the results of its internal analyses and modeling, as well as include that information in its quarterly procurement filings to the Commission.

In general, we expect SCE and California's other investor-owned electric utilities to have extensive knowledge of natural gas markets and more expertise about hedging in those markets than we do in the regulatory sphere. The utilities have the responsibility of providing reliable service to their customers at just and reasonable rates. Thus, we find it prudent to allow SCE to enter into hedging transactions at the earliest possible date. In the long term, we prefer to establish an incentive mechanism to encourage SCE to enter prudent hedging transactions to meet or beat an identified market benchmark. Such a mechanism should balance risks and rewards for transactions and help align SCE's incentives with further reductions in ratepayer costs. But at the present time, we do not have before us a sufficiently well-developed mechanism to adopt for purposes of the authority requested in this motion. Although ORA's NYMEX benchmark proposal is well-intentioned, we are not convinced that the benchmark is the most appropriate for this purpose, in the absence of other alternatives.

We also do not have any evidence that SCE and its shareholders stand to benefit from any of the proposed hedging transactions. While we are sympathetic to ensuring that these transactions are cost-effective, we are convinced by SCE's and SDG&E's comments that reliance on particular models or other instruments for an up-front measure may not be appropriate for all

types of transactions. The hedges will be occurring in a liquid market. In some cases, the transactions may be analogous to buying insurance, where a direct comparison between the cost of the insurance and the value of the risk cannot be made. While we prefer to adopt a reasonable up-front standard for cost-effectiveness in the future, we are not convinced that we have enough information to establish this standard or to choose particular models now.

Instead, to protect against risk to ratepayers, in addition to the volume limits proposed by SCE in its original motion, we will also limit the time period that authorized hedge transactions may cover. The authority granted in this decision will only extend until we adopt or modify SCE's 2004 procurement plan. To avoid today's decision potentially rendering the gas hedging portions of the 2004 procurement plan irrelevant, we will not allow SCE to enter into any gas hedging transactions for QF gas that extend beyond July 1, 2004. The first half of 2004 is the critical time period that needs to be hedged between now and our year-end decision. We also note that SDG&E and PG&E already have authority to hedge through the end of the first quarter of 2004 under their adopted 2003 short-term procurement plans while SCE's existing hedging authority is under the terms of its Settlement Agreement and expires December 31, 2003 (see D.03-02-033).

We find that with the addition of a time limit discussed above, SCE should have interim authority to hedge the natural gas prices risks for its 2004 QF contracts. Therefore, we should grant SCE's request with this modification.

We are concerned that SCE requested expedited consideration rather than submitting its formal request earlier. Informal discussion with the PRG group is to augment, not substitute, for formal Commission review and a full public review and comment period. SCE could, and should, have filed in sufficient time to provide for a normal review period and we put SCE on notice that in the

future, we will not entertain such expedited motions for authority that could reasonably have been anticipated considerably in advance of the motion.

5. Comments on Alternate Draft Decision

In its September 9, 2003 motion, SCE stated that it had discussed the relief sought in its motion with the members of its PRG and believed that the motion will be uncontested. Therefore, it requested the Commission waive the public review and comment period on the draft decision under the provisions of Rule 77.7(f)(2) of the Commission's Rules of Practice and Procedure (Rule 77.7(f)(2)). However, based on SCE's September 25, 2003 reply, this is a contested matter and we cannot waive public review under this provision.³

Under Rule 77.7(f)(9), the Commission may reduce or waive the period for public review and comment if required by public necessity. We find that the public need to quickly grant SCE interim authority to hedge its natural gas price risk associated with 2004 QF contracts clearly outweighs the public interest in having the full 30-day period for review and comment. Therefore, under the authority of Rule 77.7(f)(9), the period for public review and comment is reduced. The alternate draft decision was served on parties on October 8, 2003, with comments due by October 10, 2003.

Comments were timely filed on October 10, 2003 by SCE, ORA, and TURN. On October 14, 2003, SDG&E filed a motion for acceptance of late-filed comments. We agree with SDG&E that the time for filing comments was extremely short and that the Commission's deliberations benefit from further

³ In its September 9, 2003 motion, SCE also requests we waive public review and comment under Rule 77.7(g). SCE purports to define other parties' consent under this rule. We do not agree with SCE's interpretation, but do not find it necessary to further address the issue here.

information on the important matters addressed in this decision. For good cause shown, we grant SDG&E's motion. We have also made numerous changes in the body of this decision in response to comments filed by all four parties.

6. Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner and Christine M. Walwyn is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. SCE's request for interim authorization to begin hedging a confidentially-specified portion of its first and second quarter 2004 natural gas price risk for existing QF contracts is generally reasonable.
2. SCE's proposed methodology for setting the maximum volume limits on trading, as set forth in Appendix A of its motion, is reasonable for this requested interim authority.

Conclusions of Law

1. SCE should be granted its requested interim authorization to hedge its confidentially-specified percentage of its first and second quarter 2004 natural gas price risks for its existing QF contracts.
2. SCE should have its interim authority for hedging limited to transactions during the time period prior to July 1, 2004. This interim authority should expire once the Commission issues a decision on SCE's 2004 Short Term Procurement Plan.
3. SCE should provide the Commission and all interested parties adequate time and opportunity to review formal procurement requests.
4. The time for public review and comment on the draft decision should be reduced because the public need to quickly grant SCE interim authority to hedge

its natural gas price risk associated with 2004 QF contracts clearly outweighs the public interest in having the full 30-day period for review and comment

5. This decision should be effective immediately because SCE needs this interim authority now.

O R D E R

IT IS ORDERED that:

1. Southern California Edison Company (SCE) is granted interim authorization to hedge the confidentially-specified portion of its first and second quarter 2004 natural gas price risks for its existing Qualifying Facility contracts.

2. This interim authority shall expire once the Commission issues a decision on SCE's 2004 Short Term Procurement Plan.

This order is effective today.

Dated October 16, 2003, at San Francisco, California.

MICHAEL R. PEEVEY
President

GEOFFREY F. BROWN
SUSAN P. KENNEDY
Commissioners

I will file a concurrence.

/s/ SUSAN P. KENNEDY
Commissioner

I reserve the right to file a dissent.

/s/ CARL W. WOOD
Commissioner

I reserve the right to file a dissent.

R.01-10-024 COM/MP1/jf2/acb

/s/ LORETTA M. LYNCH
Commissioner

CONCURRING OPINION of Commissioner Susan P. Kennedy:

I support the Alternate Decision by President Peevey, which allows Edison to hedge gas price risk for its contracts with certain qualifying facilities. The Proposed Decision would have micromanaged utilities with layers of criteria and requirements for hedging, and by dictating what type of financial instruments they could use. Winter is approaching – we cannot afford to micromanage the utilities, because it is the ratepayers who will suffer from the potential delay. Every newspaper in the state is declaring that gas prices are going to increase by 30% in the very near future. The Commission needs to understand when to regulate and when to get out of the way. This issue is an example of the latter – when it comes to hedging, the utilities are in the best position to protect their customers against gas price spikes.

The Commission does not need to be involved in the details —what type of hedge the utilities should enter into, what is the proper measure for cost-effectiveness, or how we value a specific hedge. I strongly believe that this Commission should instead be establishing an upfront standard, or benchmark, that the utilities are required to meet – and then providing incentives for beating that standard. This approach allows the utilities to get on with their business, while maintaining sufficient regulatory oversight, and is in stark contrast to the micromanagement the Proposed Decision would have us embark upon.

/s/ SUSAN P. KENNEDY
Susan P. Kennedy

October 16, 2003
San Francisco, California

